

**BEFORE THE  
PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA**

**IN RE:   Application of SOUTH CAROLINA    )  
         ELECTRIC & GAS COMPANY for    )  
         Adjustments in the Company's    )  
         Electric Rate Schedules and Tariffs  )**

**Docket No. 2004-178-E**

**DIRECT TESTIMONY OF  
LABROS E. PILALIS, MPA, JD  
RESEARCH ANALYST  
RHODS & SINON GROUP LLC**

**FOR THE STAFF OF THE  
SOUTH CAROLINA  
PUBLIC SERVICE COMMISSION**

**SUBMISSION DATE: OCTOBER 18, 2004**

1    **Q     Please state your name and business address.**

2    **A**My name is Labros E. Pilalis. My business address is Rhoads and Sinon  
3           Group LLC, One South Market Square 12<sup>th</sup> Floor, P.O. Box 1146, Harrisburg,  
4           Pennsylvania , 17108-1146.

5    **Q     By whom are you employed and in what capacity?**

6    **A**I am employed by the Rhoads and Sinon Group LLC ( “R&S LLC”) as a  
7           Research Analyst.

8    **Q     On whose behalf are you appearing in this proceeding?**

9    **A**I am appearing on behalf of the Staff of the Public Service Commission of  
10          South Carolina (“Commission” or “SC PSC”).

11   **Q     Please summarize your professional experience and educational background.**

12   **A**My professional experience in the field of public utility regulation exceeds 22  
13          years. In 1982-1993 I was employed by the Economics and Finance Division of the  
14          Indiana Utility Regulatory Commission (“IURC”) where I rose to the position of  
15          Assistant Chief Economist. As an IURC staff member I participated in numerous  
16          formal adjudication proceedings where I submitted staff reports and recommenda -  
17          tions on the cost of common equity capital for regulated investor and non-investor  
18          owned public utilities , and on specialized issues of electric and telecommunications  
19          utility regulation. As an advisory staff member I assisted IURC Commissioners and  
20          Administrative Law Judges (“ALJs”) during the conduct of evidentiary hearings and  
21          with the drafting of final orders. I also actively participated in the drafting of IURC  
22          proposed administrative rulemakings.

1           In 1993-1998 I was employed by the Office of Special Assistants and the  
2           Bureau of Fixed Utility Services, Pennsylvania Public Utility Commission (“P a.  
3           PUC”). During my tenure with the Pa. PUC I supervised an interdisciplinary staff  
4           team of financial analysts and engineers and provided technical advice on a wide  
5           range of telecommunications regulation issues. Major projects included the  
6           implementation of Pennsylvania’s Alternative Form of Regulation for Telecommuni -  
7           cations Services Law, and of the federal Telecommunications Act of 1996. I was also  
8           actively involved in the drafting of Pa. PUC proposed administrative rulemakings  
9           dealing with the regulation of telecommunications carriers and services. In 1998 -  
10          2002 I was employed as an associate attorney with Rhoads and Sinon LLP, a private  
11          law firm in Harrisburg, Pennsylvania. My duties primarily centered on assisting in  
12          the legal representation of competitive telecommunications and energy utilities  
13          operating in Pennsylvania. I have held my present position since January 2003. My  
14          primary responsibilities involve the implementation of state telecommunications  
15          universal service mechanisms that are administered by R&S LLC, and the provision  
16          of consulting services on public utility and telecommunications regulation issues.

17                I received my Bachelor of Arts degree with a major in physics from the  
18                University of Nebraska, at Lincoln, Nebraska in 1978. I graduated with a Master’s  
19                Degree in Public Affairs (Public Administration) from the School of Public and  
20                Environmental Affairs, Indiana University, Bloomington, Indiana, in 1978. I  
21                received my Doctor of Jurisprudence degree from the School of Law, Indiana  
22                University, Indianapolis, Indiana, in 1989.

23   **Q       What is the purpose of your testimony?**

1     **A**           The purpose of my study and testimony is to provide an estimate and  
2           recommendation on the cost of common equity capital that can be utilized in the  
3           derivation of the overall cost of capital and the rate of return that South Carolina  
4           Electric and Gas Company (“SCE&G”) can have the opportunity to earn on its  
5           regulated operations in the context of this proceeding.

6     **Q     Please describe the general parameters for estimating the appropriate cost rate**  
7     **for the common equity capital of SCE&G.**

8     **A**           The estimation of a fair rate of return on the common equity capital of a  
9           regulated public utility, or alternatively the utility’s cost of common equity, is  
10          determined within the context of public utility regulation, and is utilized in the  
11          calculation of the utility’s overall rate of return or weighted cost of capital. Unlike  
12          debt and preferred equity capital which have explicitly stated cost rates, the cost rate  
13          of the common equity capital can only be estimated. This cost rate will vary  
14          depending upon several factors including but not limited to:

- 15          --       General financial and economic conditions;
- 16          --       Industry-specific operating conditions; and
- 17          --       Firm-specific operating conditions.

18          The cost of common equity capital for both regulated and unregulated  
19          enterprises is determined in the financial markets as the rate of return of common  
20          equity investors in such enterprises. If the return allowed by the regulatory process  
21          on the common equity capital of a regulated utility is lower than what is demanded by  
22          investors in the financial markets, then the regulated utility enterprise may be unable  
23          to attract sufficient capital at a reasonable cost for meeting the long -term demand for

1 its services. However, if the allowed rate of return on the common equity capital of a  
2 public utility is set by the regulatory process at a level higher than that required by  
3 investors in the financial markets, then the regulated firm will be wasting scarce  
4 capital resources by providing a higher rate of return to investors than what is needed.  
5 Correspondingly, the utility's ratepayers will be paying higher than appropriate and  
6 reasonable prices for the services that they receive.

7 **Q On what basis can you estimate SCE&G's market-based cost of common equity**  
8 **rate?**

9 **A** SCE&G does not have common equity stock securities that are publicly  
10 traded. Therefore, I have chosen to rely on relevant market-based information of the  
11 publicly traded common stock securities of SCANA Corporation ("SCANA").  
12 SCANA is SCE&G's corporate parent, and SCE&G is SCANA's principal regulated  
13 utility subsidiary. I have also relied on the same type of market-based information  
14 for the proxy group of holding companies with regulated electric and gas public  
15 utility subsidiaries that have been utilized in the cost of capital Direct Testimony of  
16 Dr. Burton G. Malkiel that has been submitted on behalf of SCE&G in this  
17 proceeding.

18 **Q Do you agree with the proxy group of holding companies that have public utility**  
19 **subsidiaries that has been selected by certain SCE&G witnesses in this**  
20 **proceeding and used by Dr. Malkiel in his submitted cost of capital Direct**  
21 **Testimony?**

22 **A** I have simply considered this proxy group of holding companies as a broadly  
23 representative sample of enterprises with public utility subsidiaries and publicly

1           traded common equity securities that can provide market -based information that is  
2           useful for the estimation of the cost of common equity capital for the regulated  
3           intrastate electric utility operations of SCE&G. I have not conducted any studies and  
4           I do not express an opinion on whether additional enterprises with public utility  
5           operations should have been included in this group, or whether any of the holding  
6           companies included in the proxy group should have been excluded.

7   **Q.   Do you have an opinion on whether the use of these particular public utility**  
8   **holding companies in the proxy group increases or decreases the representative**  
9   **common equity risk for the hypothetical investor in the regulated intrastate**  
10   **electric utility operations of SCE&G with commensurate effects on its cost of the**  
11   **common equity capital?**

12   **A.**           The use of the market-based information for publicly traded stock securities of  
13           holding companies with public utility subsidiaries invariably reflects the risks that  
14           these holding companies face in the domestic regulated and unregulated operations of  
15           their respective subsidiaries, as well as any risks of any overseas ventures in which  
16           these holding companies and their subsidiaries may be respectively involved. The  
17           financial markets may also deem the publicly traded common stock shares for certain  
18           of these holding companies as being exposed to greater business risks if their  
19           respective public utility subsidiaries operate under more competitive conditions, e.g.,  
20           under conditions of retail electric competition. Such risks cannot be easily quantified  
21           and extracted from the market-based information of proxy holding companies with  
22           public utility subsidiaries in such a manner so that we can estimate the “bare bones”  
23           cost of common equity for the more traditional intrastate operations of a regulated

1 electric and gas utility. However, the reasonable inclusion of such proxy risks in the  
2 cost of common equity estimation for a regulated intrastate electric operations of a  
3 public utility enterprise such as SCE&G provides for a more conservative cost of  
4 common equity estimate that includes a reasonable level of prospective anticipation  
5 of such risks.

6 **Q Why have you included SCANA in your study and estimation of the cost of**  
7 **common equity capital for SCE&G?**

8 **A** As I previously stated SCANA is the corporate parent of SCE&G. Any  
9 common equity investor performing a positive assessment of the operational,  
10 financial, and business performance and risks of SCE&G will have to purchase the  
11 publicly traded stock securities of SCANA so that he/she can be a common equity  
12 investor in SCE&G itself. Furthermore, SCE&G's total operations account for most  
13 of SCANA's consolidated assets and earnings. For example, an investment house  
14 report stated that SCE&G's earnings before interest and taxes constitute 77% of the  
15 corresponding figure for SCANA.<sup>1</sup> Similarly, SCE&G's net utility plant assets of  
16 \$5,016 million represented 78.17% of the corresponding \$6,417 million figure of its  
17 corporate parent as of December 31, 2003.<sup>2</sup> Also, SCE&G's total operating revenues  
18 of \$1,832 million constituted 53.63% of SCANA's total operating revenues of \$3,416  
19 million as of December 31, 2003.<sup>3</sup> SCE&G's net income of \$213 million after the  
20 payment of preferred stock dividends accounted for 75.53% of SCANA's net income

---

<sup>1</sup> G. Gary Garcia, *SCANA Corp. (SCG)*, Wachovia Securities Fixed Income Research, July 6, 2004, Exhibit 7, p. 7; SCE&G response to SC PSC Staff data request, *Various Analysts' Reports on SCANA Corporation*, Vol. 3 of 3, Tab 97.

<sup>2</sup> SCANA Corporation *et al.*, *Form 10-K Annual Report to the U.S. Securities and Exchange Commission*, for the Fiscal Year ending December 31, 2003, pp. 55, 109; SCE&G response to SC PSC Staff Data Request No. 1, Question No. 21.

<sup>3</sup> *Id.*, pp. 57, 111.

1 of \$282 million as of December 31, 2003.<sup>4</sup> Therefore, I have concluded that it is  
2 appropriate to consider the market-based information of SCANA's publicly traded  
3 common stock when estimating the cost of common equity capital for SCE&G.

4 **Q What methodologies did you use in estimating the cost of common equity capital**  
5 **for SCE&G?**

6 **A** I used the Discounted Cash Flow ("DCF") and the Capital Asset Pricing  
7 Model ("CAPM") methods.

8 **Q Please provide a description of the DCF method.**

9 **A** The DCF method is based on the economic principle that nothing has value  
10 except to the extent that it can produce income. Hence, a share of common stock is  
11 purchased for the income that it will produce. The only value of this common stock  
12 share today is the present value of its expected stream of future income that is  
13 comprised of dividends and/or capital gains based upon a certain discount rate. The  
14 cost rate of common equity capital that is estimated through the DCF method is this  
15 discount rate that equates the present value of these income streams to the current  
16 market price of the common stock.

17 A simple mathematical representation of the basic DCF model is as follows:

18 
$$K = (D_1/P_0 + g)$$

19 Where K is the required rate of return on common equity, D<sub>1</sub> is the expected cash  
20 dividend per share for the next period, P<sub>0</sub> is the current stock price, and g is the  
21 expected growth rate. The values chosen for these three variables obviously affect  
22 the value of the computed K.

23 The assumptions utilized in the above model are:

---

<sup>4</sup> *Id.*



- a. A multi-period model with perpetual company life;
- b. Constant expected return over time, i.e., constant  $K$ ;
- c. Constant growth in cash dividends, i.e., constant  $g$ ; and
- d. Same growth rate for cash dividends, earnings, and stock prices.

The latter assumption implies a constant dividend payout ratio and a constant price - earnings multiple over time.

**Q Please describe how you derived the base dividend yield  $D_0$ .**

**A** I used average historic dividend yields for SCANA and each of the proxy holding companies for the October 2003 – October 2004 time period for SCANA and each of the proxy holding companies. The precise derivation is contained in Appendix A to my study and direct testimony. A comparison of the base  $D_0$  dividend yields with the corresponding figures of Dr. Malkiel's direct testimony for SCE&G is as follows:

<b>Table 1</b> <b>Comparison of Base Dividend Yields (<math>D_0</math>)<sup>5</sup></b> <b>(All Figures In %)</b>		
<b>Company</b>	<b>SCE&amp;G</b>	<b>Staff</b>
SCANA	N/A	4.07
Energy East Corp.	4.3	4.36
NSTAR	4.7	4.57
Pinnacle West Capital Corp.	4.5	4.59
Vectren Corp.	4.6	4.82
Wisconsin Energy	2.6	2.57
WPS Resources	4.7	4.76

**Q What sources did you use for the derivation of the base dividend yields?**

<sup>5</sup> SCE&G, Dr. Malkiel Direct Testimony, Table 1, p. 19; Staff Direct Testimony, Appendix A.

1     **A**             I utilized a number of monthly issues of the Standard and Poor's *Stock Guide*  
2             and five (5) Sunday editions of the newspaper *The New York Times*. The September  
3             – October 2004 dividend yields reflect 5 -week averages that reflect the high and low  
4             values of individual stock prices in a particular week.

5     **Q     Please explain the derivation of the dividend growth rate g.**

6     **A.**             I based the derivation of the dividend growth rate g on the projected rates of  
7             growth for earnings per share ("EPS") for each of the enterprises that are included in  
8             my DCF cost of common equity estimation study.

9     **Q     Please explain why you excluded projected growth rates for dividends per share**  
10            **("DPS") from your calculations.**

11    **A**             It is my opinion that generally the consideration of projected DPS growth is  
12             appropriate in DCF calculations. I chose to rely exclusively on the projected EPS  
13             growth rates because actual cash DPS are derived from the EPS of a publicly traded  
14             enterprise depending on its dividend payout policy, and the use of the projected EPS  
15             growth rates produced an overall more conservative DCF estimate of the cost of  
16             common equity for SCE&G.

17    **Q     What sources did you use for the projected long-term EPS growth rates?**

18    **A**             I used the Value Line Investment Survey ("Value Line"), the EPS growth rates that  
19             can be found at the Yahoo Finance Internet web site <<http://finance.yahoo.com>>, and  
20             the EPS projected growth rates supplied by the Charles Schwab ("Schwab")  
21             brokerage firm.

22    **Q     Why did you not use the I/B/E/S and the First Call projected EPS growth rates**  
23            **that were utilized by Dr. Malkiel in his direct testimony for SCE&G?**

1    **A**       I did not have readily available access to the I/B/E/S and First Call source materials  
2               utilized by Dr. Malkiel.<sup>6</sup>

3    **Q**       **What is your opinion about the validity and reliability of the sources that you**  
4               **used for the projected long-term EPS growth rates?**

5    **A**       I consider these sources to be valid and reliable. Value Line is used by a wide  
6               segment of the investing public and is available in various public libraries. Value  
7               Line has been and is used in DCF cost of common equity estimates within the context  
8               of various adjudication proceedings before state utility regulatory commissions. The  
9               long-term growth EPS projections contained at the Yahoo Finance Internet web site  
10              are publicly available and rely on estimates and information supplied by Thomson  
11              Finance. Thomson Finance is the financial services firm that also owns the I/B/E/S  
12              and First Call service brands. Schwab relies on information and estimates supplied  
13              by Reuters Research, Standard & Poor's, and Morgan Stanley Capital International,  
14              Inc.

15   **Q**       **Please describe the derivation of the dividend growth rate  $g$  from the long-term**  
16               **EPS projected growth rates.**

17   **A**       The derived dividend growth rate  $g$  for each of the enterprises included in my DCF  
18               calculations is essentially the arithmetic average of the corresponding data from the  
19               three sources that I utilized. The derivation is clear in Appendix A of my study and  
20               direct testimony. Below is a comparison with the dividend growth rates that were  
21               utilized by Dr. Malkiel in his direct testimony on behalf of SCE&G:

---

<sup>6</sup>See generally SCE&G Response to Interrogatories of the Consumer Advocate Set No. 2, Item No. 22.

1

<b>Table 2</b> <b>Comparison of Dividend Growth Rates (g)<sup>7</sup></b> <b>(All Figures In %)</b>							
Company	SCE&G			Staff			
	I/B/E/S	First Call	Average	Value Line	Yahoo-Thomson	Schwab	Average
SCANA	N/A	N/A	N/A	5.50	4.50	4.40	4.80
Energy East Corp.	4.5	4.5	4.5	3.50	4.00	4.40	3.97
NSTAR	4.3	4.3	4.3	3.00	5.00	4.30	4.10
Pinnacle West Capital Corp.	4.6	4.6	4.6	4.00	4.50	5.20	4.57
Vectren Corp.	7.0	7.0	7.0	5.00	7.00	7.00	6.33
Wisconsin Energy	6.3	6.8	6.6	6.00	6.00	6.10	6.03
WPS Resources	6.4	6.4	6.4	3.50	5.00	4.30	4.27

2

3 **Q Please explain the derivation of the forward dividend yield  $D_1$ .**

4 **A** The forward dividend yield represents the growth of the base dividend yield  
 5  $D_0$  by the growth rate  $g$  for a single period. I have chosen a full annual period for the  
 6 calculation of the forward dividend yield  $D_1$ . The comparison of the resulting  
 7 forward dividend yields with the corresponding figures in the direct testimony of Dr.  
 8 Malkiel for SCE&G can be found below:

<b>Table 3</b> <b>Comparison of Forward Dividend Yields (<math>D_1</math>)<sup>8</sup></b> <b>(All Figures In %)</b>		
Company	SCE&G	Staff
SCANA	N/A	4.27
Energy East Corp.	4.5	4.53
NSTAR	4.9	4.76
Pinnacle West Capital Corp.	4.7	4.80
Vectren Corp.	4.9	5.12
Wisconsin Energy	2.8	2.73
WPS Resources	5.0	4.97

9

<sup>7</sup> SCE&G, Dr. Malkiel Direct Testimony, Table 1, p. 19; Staff Direct Testimony, Appendix A.

<sup>8</sup> *Id.*

1 **Q Please describe the derivation of the estimates for the cost of common equity**  
 2 **capital for the enterprises included in your DCF method calculations.**

3 **A** The DCF cost rate of common equity (K) estimates for each of these  
 4 enterprises is derived as the sum of the respective forward dividend yields (  $D_1$ ) and  
 5 growth rates (g). The results of this calculation and the corresponding figures from  
 6 the direct testimony of Dr. Malkiel for SCE&G are depicted below:

<b>Table 4</b> <b>Comparison of DCF Cost Rate of Common Equity Estimates (K)<sup>9</sup></b> <b>(All Figures In % - Without Adjustments for Flotation Costs)</b>		
<b>Company</b>	<b>SCE&amp;G</b>	<b>Staff</b>
SCANA	N/A	9.07
Energy East Corp.	9.0	8.50
NSTAR	9.2	8.86
Pinnacle West Capital Corp.	9.3	9.36
Vectren Corp.	11.9	11.46
Wisconsin Energy	9.3	8.76
WPS Resources	11.4	9.23

7  
 8 **Q How do you derive your DCF method recommended cost rate for the common**  
 9 **equity capital of SCE&G?**

10 **A** I initially average the DCF cost of common equity estimates of the six (6)  
 11 enterprises that are members of the proxy group of companies. This average cost of  
 12 common equity rate is 9.36%. I then average this figure with SCANA's stand-alone  
 13 DCF cost of common equity capital of 9.07%. My adopted and recommended DCF-  
 14 based cost rate for the common equity capital of SCE&G is **9.21%**.

15 **Q Please provide a description of the CAPM model.**

16 **A** The CAPM states that the investor's expected rate of return for a security is  
 17 equal to a rate of return on risk-free securities plus a risk premium which is

---

<sup>9</sup> *Id.*

1 proportional to the systematic risk (market-related risk) of this security. The CAPM  
2 is one version of the risk premium model. In addition to the risk-free rate of return,  
3 investors in a security require an additional return for incremental risk. In determin -  
4 ing the cost rate of common equity capital, the CAPM method is premised on the  
5 thesis that this cost rate is the rate of return currently and prospectively demanded by  
6 an investor in the financial markets. However, unlike the DCF method, the CAPM  
7 not only explicitly accounts for the investor's minimum opportunity cost by taking  
8 the return on risk-free securities into consideration, it also explicitly specifies the  
9 risk-return relationship by using a special risk measure, Beta (B), which is a measure  
10 of systematic risk. The CAPM defines risk as the volatility of returns over time and  
11 categorizes risk into two kinds. These are the systematic or market-related risk and  
12 unsystematic or non-market-related risk. The non-market risk can be eliminated by  
13 the proper diversification of securities in the composition of an investment portfolio.  
14 Thus, non-market risk is theoretically not important in the CAPM application.  
15 Market-related risk cannot be diversified away and requires an appropriate return for  
16 compensation.

17 With a number of assumptions, the CAPM formula for estimating the cost of  
18 common equity capital can be established with the following formula:

$$R_i = R_f + B_i * (R_m - R_f)$$

20 Where:

21  $R_i$  is the expected return on a risky security or the cost of common equity;

22  $R_f$  is the return on a risk-free security;

23  $B_i$  is the expected systematic risk of the security; and

1  $R_m$  is the market return.

2 Major assumptions of the CAPM in deriving the above risk -return relationship are:

- 3 a. A single-index single -period (static) model.
- 4 b. Capital markets are perfect. There are no transaction costs or taxes , and information
- 5 is costless and available to ever yone.
- 6 c. Investors are risk averse and make decisions to maximize their expected utility of
- 7 wealth.
- 8 d. There is a risk -free investment opportunity available to all investors and the risk -free
- 9 rate of return can be correctly estimated.

10 **Q. Please describe the estimation of the CAPM parameters and your application of**

11 **this method.**

12 **A** In applying the CAPM when determining the cost of common equity capital

13 the following important parameters need to be estimated: (1) The enterprise -specific

14 Beta ( $B_i$ ); (2) the market equity risk premium ( $R_m - R_f$ ); and (3) the rate of return on

15 risk-free securities ( $R_f$ ).

16 **Q Please discuss your selection and source of the enterprise-specific Betas that you**

17 **utilized in your CAPM calculations.**

18 **A** I utilized the enterprise -specific Betas that are published by Value Line. To

19 the best of my information, knowledge and belief these are “adjusted Betas” and are

20 widely used in producing CAPM cost of common equity estimates for regulated

21 enterprises.

22 **Q Please discuss your adoption and source of the market equity risk premium that**

23 **you utilized in your CAPM calculation.**

1     **A**           I utilized an approach that was designed to produce an overall conservative  
2           estimate of the common equity return for SCE&G based on the CAPM method. I  
3           utilized both the geometric and arithmetic mean risk premium figures for large and  
4           small company stocks as those can be derived from the respective returns for such  
5           stocks and the risk-free returns from intermediate -term government securities. The  
6           adopted risk premium of 7.80% is an overall average of these risk premium values.<sup>10</sup>

7     **Q     Does this choice of risk premium account for the fact that the Ibbotson**  
8           **Associates stock returns are calculated on the basis of “achieved” rather than**  
9           **“expected” returns?**

10    **A**           I believe that it does because it implicitly takes into consideration the higher  
11           returns but also the higher volatility – and hence higher systematic risk levels – for  
12           small company stocks. When calculating CAPM required returns for regulated  
13           enterprises we usually deal with stocks with less volatility or less systematic risk than  
14           the overall market, i.e., the Betas of these stocks are usually less than 1.00. As I  
15           explain below, an additional factor in my CAPM calculations compensates for the  
16           fact that the Ibbotson Associates stock returns and resulting risk premiums are based  
17           on “achieved” rather than on “expected” returns.

18    **Q     Please describe your selection of the return on risk-free securities that you**  
19           **utilized in your CAPM calculations.**

20    **A**           Appendix B of my study and testimony contains both historic and projected  
21           rates on risk-free intermediate and long -term U.S. Treasury Notes. Although it is  
22           appropriate to rely on both historic and projected figures in deriving the risk -free

---

<sup>10</sup> Ibbotson Associates, Inc., *Stocks, Bonds, Bills, and Inflation 2004 Yearbook: Market Results for 1926-2003*, (Chicago, IL 2004), Table 2-1, p. 33. See also Appendix B.



security return rate in CAPM calculations, I have chosen to rely on the average projected figure of 4.89% for 10-year U.S. Treasury Notes. This represents my personal judgment on the most likely direction of returns for U.S. Treasury Notes. My choice for a risk-free return rate also provides an additional increment of return in my CAPM calculations that offsets the fact that the Ibbotson Associates stock returns and resulting risk premiums are based on “achieved” rather than “expected” return figures. Please note that these risk premiums are computed between the stock returns and *intermediate-term* risk-free government securities.

**Q Please summarize the results of your CAPM calculations of the cost of common equity capital for SCE&G.**

**A** The CAPM calculation results for the cost of common equity of SCE&G are summarized below:

<b>Table 5</b> <b>Summary of CAPM Cost Rate of Common Equity Estimates (K)<sup>11</sup></b> <b>(Without Adjustments for Flotation Costs)</b>				
<b>Company</b>	<b>Beta</b>	<b>Risk Premium (%)</b>	<b>Risk-Free Rate (%)</b>	<b>CAPM Return (%)</b>
SCANA	0.70	7.80	4.89	10.35
Energy East Corp.	0.80	7.80	4.89	11.13
NSTAR	0.70	7.80	4.89	10.35
Pinnacle West Capital Corp.	0.80	7.80	4.89	11.13
Vectren Corp.	0.75	7.80	4.89	10.74
Wisconsin Energy	0.70	7.80	4.89	10.35
WPS Resources	0.75	7.80	4.89	10.74
<b>Average of proxy group</b>				10.74
<b>Average with SCANA</b>				10.55

<sup>11</sup> See Appendix B.

1    **Q       How do you derive your CAPM method recommended cost rate for the common**  
2       **equity capital of SCE&G?**

3    **A**I initial ly averaged the CAPM cost of common equity estimates of the six (6)  
4       enterprises that are members of the proxy group of companies. This average cost of  
5       common equity rate is 10.74%. I then average this figure with SCANA's stand -alone  
6       CAPM cost of common equity capital of 10.35%. My adopted and recommended  
7       CAPM-based cost rate for the common equity capital of SCE&G is **10.55%**.

8    **Q.       What is your overall cost of common equity recommendation for SCE&G?**

9    **A**By giving equal weight to my DCF and CAPM cost of common e quity estimates of  
10     9.21% and 10.74% respectively, my overall recommendation for the rate of return on  
11     the common equity capital of SCE&G is **9.88%**.

12   **Q       Does your recommended cost of common equity rate for SCE&G's intrastate**  
13     **regulated operations include an adjustment for the flotation costs of issuing new**  
14     **securities?**

15   **A**No it does not.

16   **Q       Please state whether you are absolutely opposed to the recovery by SCE&G's**  
17     **intrastate regulated operations of its flotation costs that may relate to the**  
18     **issuance of new common stock on its behalf by SCANA, SCE&G's corporate**  
19     **parent?**

20   **A.**I am not opposed to the rate recovery of SCE&G's legitimate, proportional,  
21     and reasonable flo tation costs associated with prospective common stock issuances  
22     made by SCANA, SCE&G's corporate parent, where the net capital proceeds will be  
23     allocated totally or in part to SCE&G's intrastate regulated operations as a common

1 equity capital contribution from SCANA to SCE&G. However, I am of the opinion  
2 that this rate recovery should take place as the normal rate recovery of an expense  
3 item and not as a flotation cost adjustment to SCE&G's authorized rate of return on  
4 its common equity capital of its intrastate regulated operations.

5 **Q Please explain your reasons.**

6 First, a flotation cost adjustment can be applied only to a DCF derived cost of  
7 common equity estimate. Applying a flotation cost adjustment to a CAPM derived  
8 cost of common equity figure violates one of the fundamental premises of the CAPM  
9 method in that capital markets are perfect, there are no transaction costs or taxes, and  
10 that information is costless and available to everyone. Flotation costs for the issuance  
11 of new common equity securities constitutes transaction costs in the financial  
12 markets.

13 Second, the cost of common equity estimate for a regulated enterprise reflects  
14 *a prospective capital cost*. At this point there is no readily available information that  
15 SCANA in the near future will be issuing new common stock where the net proceeds  
16 of such issuance will be totally or in part allocated to SCE&G's intrastate regulated  
17 operations.<sup>12</sup> Consequently, we cannot estimate with certainty or approximate  
18 precision the *prospective* value of a flotation cost adjustment that could be applied to  
19 a DCF derived cost of common equity estimate for the intrastate regulated operations  
20 of SCE&G.

21 Third, there is a need to *allocate* through some reasonable method the  
22 flotation costs of new common stock that SCANA issues where the net proceeds are

---

<sup>12</sup> SCE&G response to SC PSC Staff Data Request No. 1, Item No. 8; and SCE&G direct testimony of Dr. Malkiel, Lines 13 -15, p. 21, ("While there are no present plans for new equity or debt issues, over time there will be a need for additional outside capital").

1 allocated as common equity capital contributions among its regulated and unregulated  
2 subsidiaries and affiliates. To adjust the DCF cost of common equity estimate of  
3 SCE&G's intrastate regulated operations for the full flotation cost of any common  
4 stock issuance by SCANA presents some inherent problems. This approach  
5 implicitly assumes either that the full amount of the net proceeds from SCANA's  
6 common stock issuance will be allocated to the intrastate retail regulated operations  
7 of SCE&G, or that these operations have the same rate of return requirement on  
8 common equity as SCANA's subsidiaries and affiliates that may operate in a more  
9 unregulated and competitive environment with inherently greater levels of financial  
10 and business risks. Neither of these assumptions may hold true. For example,  
11 SCANA may decide to allocate 85% of the net proceeds of a future common stock  
12 issuance to a totally new or existing unregulated subsidiary that is engaged in a high  
13 risk venture with a very high common equity return requirement. It would be  
14 fundamentally unfair to the ratepayers of SCE&G's regulated intrastate operations to  
15 bear the full flotation cost of that issuance as if 100% of the net proceeds had been  
16 allocated to SCE&G's intrastate regulated operations. Under such circumstances one  
17 may question whether the common stock dividend that SCE&G transmits to its parent  
18 may be a less costly source of internal financing rather than receiving the capital  
19 contribution from the net proceeds of SCANA common stock issuances.

20 Finally, recovering as a normalized expense the legitimate, proportional, and  
21 reasonable flotation costs associated with prospective common stock issuances made  
22 by SCANA, where the net capital proceeds will be allocated totally or in part to  
23 SCE&G's intrastate regulated operations as a common equity capital contribution

1 from SCANA to SCE&G, is also of benefit to SCE&G itself and to its corporate  
2 parent. If over time SCE&G's intrastate regulated operations do not attain their  
3 authorized rate of return on common equity capital it stands to reason that SCE&G  
4 does not recover the flotation costs that may be embedded as an adjustment to such  
5 an authorized return. The rate recovery of a legitimate, proportional, and reasonable  
6 expense item is definitely more assured.

7 **Q How this Commission should act on your final recommendation for a 9.88%**  
8 **return on the common equity capital of SCE&G if other reasonable alternatives**  
9 **were to be presented to the Commission for the potential non-litigated resolution**  
10 **of this proceeding?**

11 **A** I believe that my study and testimony recommendation present a reasonable  
12 estimate of the cost of common equity capital for SCE&G. However, this Commis-  
13 sion can and should consider the reasonableness of any non-litigated resolution of this  
14 proceeding that may be presented in accordance with its applicable statutory mandate  
15 and procedural rules. My study and testimony, as well as the studies and testimonies  
16 submitted by other parties in this proceeding, cumulatively present a series of  
17 estimated cost of common equity figures for SCE&G which in themselves can  
18 provide this Commission with a range of alternatives in judging the overall  
19 reasonableness of any proposed non-litigated resolution of this proceeding.

20 **Q Does this conclude your direct testimony in this proceeding?**

21 **A** Yes, it does.